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IN THE

Supreme Court of the United States

OCTOBER TERM, 1957

No. 2691

R. M. and ALMA L. GUNN; ARTHUR T. and MARGUERET SAUNDERS; R. E. and PEGGY Q. STANFORD; AINSLIE and MAE FRANCES PERRAULT; and ALLIED PAINT MANUFACTURING CO., *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgments of the United States Court of Appeals for the Tenth Circuit.

OPINIONS BELOW

The opinion of the Tax Court (Appendix A, *infra*, pp. 4a-26a) is reported at 25 T.C. 424 (1955). The opinion of the Court of Appeals (Appendix A, *infra*, pp. 1a-4a) is not yet reported.

JURISDICTION

The judgments of the Court of Appeals were entered on April 19, 1957. (Appendix C, *infra*, p.31a.) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Five individuals, engaged in business as partners, sold their assets to a corporation in which they acquired all the stock. The purchase price was represented by promissory notes of the corporation, which were payable in installments and bore interest. The ratio of the indebtedness to the equity capital of the corporation was approximately 11 to 1. The question is whether, in computing the resulting tax liabilities of the individual sellers and the corporate buyer, the Commissioner may treat the promissory notes as stock in the corporation because of the ratio of the indebtedness to its equity capital.

STATUTES INVOLVED

The pertinent statutes appear in Appendix B, *infra*, pp. 27a-30a.

STATEMENT

These consolidated proceedings involve nine taxpayers. Raymond M. Gunn and Alma L. Gunn, Arthur T. Saunders and Margueret Saunders, Robert E. Stanford and Peggy Q. Stanford, and Ainslie Perrault and Mae Frances Perrault are, respectively, husband and wife. The husbands are at times later referred to as the petitioners. Allied Paint Manufacturing Co. is a Delaware corporation with principal offices at Tulsa, Oklahoma.

The facts may be summarized as follows:

Between June 1, 1943, and September 30, 1946, the petitioners and George C. Houck, Jr. were engaged in the business of manufacturing and selling paint. They operated as a limited partnership known as Allied Paint Company, hereinafter referred to as the Partnership. Perrault was a general partner and the others were special partners. The distributive interests of Perrault, Gumm, Saunders, Stanford, and Houck were, respectively, 55.0, 17.5, 12.5, 12.5, and 2.5 percent. (R. 98-99.)

In June and July, 1946, Perrault consulted an attorney, L. Karlton Mosteller, in regard to a possible sale of the business. Mosteller and his law partner, George H. McElroy, were involved in a number of commercial ventures. Eventually they became interested in acquiring the paint business for themselves in order to resell it at a quick profit. After extended negotiations the partners agreed to sell the business for $582,773.54 to a new corporation to be formed by Mosteller and McElroy. (R. 100-102.)

On September 21, 1946, Mosteller and McElroy organized petitioner Allied Paint Manufacturing Co., hereinafter referred to as the Corporation. Its authorized capital was $50,000, consisting of 10,000 shares with a par value of $5.00 per share. On October 1, 1946, Mosteller subscribed for all the authorized shares on behalf of himself and McElroy, and a certificate for 10,000 shares was issued to him. Mosteller paid the Corporation $1,000 for 200 shares and signed a subscription agreement for the other 9,800 shares, in which he promised to pay the balance of $49,000 on demand. (R. 102-103.)

As of September 30, 1946, the balance sheet of the Partnership reflected total assets of $351,552.11, total liabilities of $47,207.54, and a net worth of $304,344.57. Its basis for its buildings and equipment was $83,019.20. On October 1, 1946, the Partnership distributed to the partners all its fixed assets, inventories, and receivables. On the same day they executed a bill of sale to the Corporation covering the same items, as well as processes and formulae of the business. The fair market value of the assets acquired by the Corporation was not less than $582,773.54. Of this total, $212,681.34 was attributable to the buildings and equipment. (R. 103-104.)

Under the bill of sale the Corporation promised to pay $50,000 on or before December 31, 1946, and the balance of $532,773.54 in ten equal annual installments on January 2nd of each of the years 1948 to 1957. The Corporation issued two notes to each of the vendors as follows:

Payees	Notes Due Dec. 31, 1946	Ten Year Installment Notes	Total
Ainslie Perrault	$27,500.00	$293,025.45	$320,525.45
R. M. Gunn	8,750.00	93,235.37	101,985.37
Arthur T. Saunders	6,250.00	66,596.69	72,846.69
R. E. Stanford	6,250.00	66,596.69	72,846.69
George C. Houck, Jr.	1,250.00	13,319.34	14,569.34
	$50,000.00	$532,773.54	$582,773.54

The notes due on December 31, 1946, were non-interest bearing. The other notes, payable in ten annual installments beginning on January 2, 1948, carried interest at three percent from December 31, 1946. Upon default in the payment of any installment, the holder could declare the entire balance due. The Corpora-

tion, as maker, reserved the right to pay any installment before its due date. On October 1, 1946, the Corporation executed a combination real estate and chattel mortgage in favor of Perrault. The mortgage secured his installment note of $293,025.45, and covered present and future assets of the Corporation. The Corporation was also obliged to secure the note by a policy of $125,000 on Perrault's life if he was insurable. The notes of the other partners were not secured. (R. 103-105.)

After the Corporation acquired the business, Mosteller found it impossible to re-sell the business promptly at a substantial profit. As a result he became very disturbed over his subscription liability of $49,000. He discussed the matter with Perrault, and finally induced Perrault to take over the stock of the Corporation. (R. 105, 110.)

On October 18, 1946, Perrault paid Mosteller $1,000 for the 200 shares previously paid for, and the Corporation released Mosteller from all liability under his subscription agreement. On the same day the petitioners and Houck subscribed for the remaining authorized capital stock of $49,000. The Corporation issued to each of them a certificate for his respective number of shares, as follows:

Stockholder.	Shares	Par Value	Percent of Total
Leslie Perrault	5,500	$27,500	55.00%
M. Gunn	1,750	8,750	17.50
Arthur T. Saunders	1,250	6,250	12.50
E. Stanford	1,250	6,250	12.50
George C. Houck, Jr.	250	1,250	2.50
Total	10,000	$50,000	100.00%

(R. 105.)

The five stockholders gave the Corporation notes covering their subscriptions for its stock. They paid $9,800 on the notes in 1948, $9,800 in 1950, $5,000 in 1952, and $5,000 in 1953. They have always been prepared to make full payment on their subscriptions. But they have preferred to pay gradually because, in their view, the Corporation has been in good financial condition and has not particularly needed the money. The bank from which the Corporation obtains credit has never criticized it for failing to require full payment. Meanwhile the five stockholders have been paying interest on the balance due. (R. 105-106, 187-188, 197-198, 202-204.)

Since October 1, 1946, the Corporation has carried on the same business as the Partnership. It keeps its books under an accrual method of accounting, and reports its income on the basis of a fiscal year ending September 30th. For the fiscal years 1947 through 1952 its sales and net profits, before adjustments by the Commissioner, were as follows:

Year	Sales	Net Profits	Federal and State Taxes	Net Profits After Taxes
1947	$1,219,780.22	$259,761.65	$103,922.03	$155,839.62
1948	1,331,348.20	141,469.87	56,203.50	85,266.37
1949	1,388,483.74	117,767.54	48,296.15	69,471.39
1950	1,647,547.73	191,943.87	79,647.08	112,296.79
1951	2,106,964.45	268,750.46	161,587.57	107,162.89
1952	2,115,974.54	209,198.55	116,375.28	92,823.27

(R. 98, 106.)

The paint manufacturing business is a seasonal industry. It is active in the spring, summer and early fall, and inactive during the rest of the year. Materials are generally purchased about three to six months before the active period of manufacture and sale be-

gins. Because of the seasonal nature of the business there is usually a seasonal fluctuation of debt. During the winter months, when business is low, the companies borrow money to finance the purchase of inventory. Later, in the peak months, the loans are repaid. Like other companies of similar size, the Partnership regularly obtained seasonal bank loans on short-term notes to help carry its inventory. The Corporation continued to do the same, and had no trouble in obtaining credit for its purchases. The bank has never criticized the Corporation for its liability on the notes held by the stockholders. (R. 106.)

The balance sheets of the Corporation at the end of its fiscal years 1947 through 1949 reflected the following cash and receivables, and earned surplus:

Year	Cash and Receivables	Earned Surplus
1947	$313,227.67	$155,839.62
1948	302,210.69	237,407.92
1949	308,208.15	309,907.62

(R. 107-108.)

The Corporation has carried the purchase money notes on its books as an indebtedness. It paid in full the notes due on December 31, 1946. It also paid all the annual installments on the 10-year notes through 1952. Since the Commissioner has treated the payments as dividends, all further payments of principal have been deferred pending a judicial determination whether his position is correct. The Corporation has had sufficient funds to pay the installments past due. Meanwhile it has regularly paid all interest on the installment notes. On June 17, 1947, the Corporation succeeded in obtaining a policy of special risk on

Perrault's life in the amount of $125,000. It then assigned the policy to him as collateral security for his installment note. (R. 41, 108-109, 227.)

The petitioners treated the payments received on their notes in 1946 and 1948 as the proceeds of a sale, and reported long-term capital gains on the installment basis. The Commissioner determined that the payments were taxable to them as dividends from the Corporation. (R. 109.)

The Corporation deducted the interest accrued on the notes in its fiscal years 1947, 1948, and 1949. The Commissioner disallowed the deductions on the ground that they represented "interest on capital stock."[1] The Corporation deducted depreciation for the same years based on its cost for the depreciable assets under the bill of sale. The Commissioner determined that the Corporation's basis was the same as the Partnership's basis for the assets. (R. 109.)

The Tax Court sustained the Commissioner's adjustments. Appendix A, *infra*, pp. 4a-26a. The Court of Appeals affirmed the opinion and conclusions of the Tax Court. Appendix A, *infra*, pp. 1a-4a.

REASONS FOR GRANTING THE WRIT

There is no dispute over the relevant facts. As the Tax Court found, the five partners transferred their Partnership property to the Corporation "solely in

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[1] With respect to the fiscal years 1947 and 1948 the Commissioner also held that even if the interest "was paid on indebtedness, it still would not constitute an allowable deduction because of the provisions of section 24(c) of the Internal Revenue Code." (R. 109.) However, in the Court of Appeals the Commissioner abandoned this alternative position. Brief for the Resp. in the Court of Appeals, p. 25.

exchange for notes totaling $582,773.54, and at the same time subscribed for all of the corporate stock." Appendix A, *infra*, p. 23a.[2] The face amount of the notes did not exceed the fair market value of the property. They were ordinary negotiable instruments, promising to pay stated sums at stated times. The obligations which they expressed were fixed and definite. Interest was payable at three percent. Neither principal nor interest was subordinated to the claims of other creditors. The installment note of Perrault was secured by a mortgage, and later by a life insurance policy as well.

Section 44(b) of the Internal Revenue Code of 1939 provides that gain realized on a sale of assets may be be reported on the installment basis. Section 23(b) enables a taxpayer to deduct "interest paid or accrued within the taxable year on indebtedness." Section 113(a) states that the basis of purchased property is

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[2] In the courts below the parties disagreed whether the partners' sale to the Corporation and their later acquisition of its stock should be treated as separate transactions or as parts of a single transaction. The Tax Court and the Court of Appeals resolved this difference in favor of the Commissioner. Specifically, both courts determined that the intervening stock ownership of Mosteller and McElroy should be disregarded, and held that the partners, in effect, acquired the stock when the sale was made. As the Tax Court put it, the sale of the assets and the acquisition of the stock were "in substance a single transaction whereby the partners subscribed for stock in a new Corporation and transferred their Partnership property to the Corporation for notes, with both the stock and the notes representing the same proportionate interest in the Corporation as they previously held in the Partnership." Appendix A, *infra*, p. 21a. See also id. at 22a-23a. The petitioners do not question this finding, which reflects the concurrent views of both courts below. *Comstock* v. *Group of Investors*, 335 U.S. 211, 214 (1948). The finding still leaves the clear-cut question of law which provides the basis for these petitions—whether the indebtedness represented by the notes may be treated as stock in the Corporation,

"the cost" to the buyer. The petitioners and the Corporation computed their taxes in response to these statutes. The petitioners reported the payments on the notes as the proceeds of a sale, and returned their gain on the installment basis. The Corporation deducted the interest accrued on the notes, and depreciation based on the purchase price of the assets. In sharp contrast, the Tax Court and the Court of Appeals have ruled that the purchase money notes constitute stock rather than indebtedness. In accordance with this legal reasoning they have held that payments of principal on the notes are taxable as dividends received on stock. Along the same lines, they have also held that the Corporation may not deduct the accrued interest because it was not interest "on indebtedness;" and that the Corporation's basis for depreciation is the same as the Partnership's basis because the property was acquired as a tax-free contribution for stock. Int. Rev. Code of 1939, § 113(a)(8)(A).

This Court has held that a corporation may sell its "assets to stockholders at fair value, subject to that incidence of taxing statutes which usually attends sales." *Palmer* v. *Commissioner*, 302 U.S. 63, 71 (1937). The converse is no less true. Stockholders may sell assets to their corporation at a fair price, similarly subject to the tax incidence "which usually attends sales." As a result, the payments which they receive are taxable to them as the proceeds of a sale. *Curran* v. *Commissioner*, 49 F. 2d 129 (8th Cir. 1931); *Miller's Estate* v. *Commissioner*, 239 F. 2d 729 (9th Cir. 1956); *Abe Ackerman*, 27 B.T.A. 413 (1932), *aff'd*, 76 F. 2d 833 (7th Cir. 1935); *Herff & Dittmar Land Co.*, 32 B.T.A. 349 (1935); *Frank W. Ross*, 44

B.T.A. 1 (1941), *remanded pursuant to stipulation*, 32 A.F.T.R. 1729 (4th Cir. 1943); *58th Street Plaza Theatre, Inc.*, 16 T.C. 469 (1951), *aff'd on other issues*, 195 F. 2d 724 (2d Cir. 1952); *cert. denied*, 344 U.S. 820 (1952); *Estate of Julius I. Byrne*, 16 T.C. 1234 (1951); *George J. Staab*, 20 T.C. 834 (1953); *Fred MacMurray*, 21 T.C. 15 (1953); *Sheldon Tauber*, 24 T.C. 179 (1955); *Ainslie Perrault*, 25 T.C. 439 (1955); *Warren H. Brown*, 27 T.C. 27 (1956). A corporate payment for assets bought from a stockholder is no more a dividend than a corporate repayment of loans made by a stockholder. See, *e.g.*, *Weaver* v. *Commissioner*, 58 F. 2d 755 (9th Cir. 1932). By the same token, the sale to the corporation creates an indebtedness with respect to its deduction of interest and its basis for depreciation. *Sun Properties* v. *United States*, 220 F. 2d 171 (5th Cir. 1955); *Hollywood, Inc.*, 10 T.C. 175 (1948); *Ainslie Perrault, supra*; *Bakhaus & Burke, Inc.*, 14 T.C.M. 919 (1955).

Here, too, the Corporation was obviously a purchaser in the usual meaning of the word—"one who acquires title for a valuable consideration in the manner of vendor and vendee." *United States* v. *Scovil*, 348 U.S. 218, 221 (1955). The notes were not in the least so-called "hybrid" instruments where the distinction between indebtedness and stock becomes elusive and obscure. See *John Kelley Co.* v. *Commissioner*, 326 U.S. 521 (1946). In the words of the Second Circuit, the notes "contained *all* the necessary features of instruments of indebtedness and *none* of the features ordinarily associated with equity interests."[3] Hence the question here is "not one of as-

[3] Italics in original.

certaining 'intent,' since the parties have objectively manifested their intent." The question, rather, is "whether the intent and acts of these parties should be disregarded in characterizing the transaction for tax purposes." *Kraft Foods Company* v. *Commissioner*, 232 F. 2d 118, 122, 123 (2d Cir. 1956). See also *Miller's Estate* v. *Commissioner, supra*, at 732. As this Court has stated, "A bondholder interest in a solvent company plainly is not the equivalent of a proprietary interest, even though upon default the bondholders could retake the property transferred." *Helvering* v. *Limestone Co.*, 315 U.S. 179, 184 (1942). What is true of a bond is true of a note. We do not see how the parties could have done much more to create an indebtedness. Indeed, each note was an indebtedness under the Treasury's own definition of the term—"an obligation, absolute and not contingent, to pay, on demand or within a given time, in cash or other medium, a fixed amount." Regulations 111, § 29.504-2(a)(1); Regulations 118, § 39.504-2(a)(1). See also Regulations 112, § 35.719-1; Regulations 130, § 40.439-1(e).

Despite the familar principles which we have summarized, the courts below have held that the purchase money notes constituted stock and not an indebtedness. This conclusion was rationalized on two grounds. The first was that each seller had the same proportionate interest in the notes as in the stock. See Appendix A, *infra*, p. 23a. But it is settled that a corporation may maintain a debtor-creditor relationship with its stockholders. See *Wilshire & West. Sandwiches* v. *Commissioner*, 175 F. 2d 718, 720 (9th Cir. 1949). And it is equally settled that the existence of a debt is not rebutted by the mere fact that the creditors own all

the stock in the same proportion as they own the debt. See *Van Clief* v. *Helvering*, 135 F. 2d 254, 256. (D.C. Cir. 1943); *Maloney* v. *Spencer*, 173 F. 2d 638, 641 (9th Cir. 1949); *Wilshire & West. Sandwiches* v. *Commissioner, supra*, at 720; *Kraft Foods Company* v. *Commissioner, supra*, at 123-125; *Daniel Gimbel*, 36 B.T.A. 539, 542 (1937); *William D. P. Jarvis*, 43 B.T.A. 439, 446 (1941), *aff'd*, 123 F. 2d 742 (4th Cir. 1941); *Toledo Blade Co.*, 11 T.C. 1079, 1084-1085 (1948), *aff'd on other issues*, 180 F. 2d 357 (6th Cir. 1950), *cert. denied*, 340 U.S. 811 (1950). Of course, this accepted rule applies where the indebtedness derives from a sale by the stockholders to their newly organized corporation. See *Sun Properties* v. *United States, supra*; *Miller's Estate* v. *Commissioner, supra*; *Ainslie Perrault, supra*; *Bakhaus & Burke, Inc., supra.*

In final analysis, then, the decision below rests on the second ground provided for its support. To quote the words which express its controlling principle, the Corporation's "ratio of form-indebtedness to form-capital" was "about 11 to 1"—purchase money notes of $582,773.54 as compared with a capitalization of $50,000. "This ratio would tend to indicate that under the circumstances here present the relationship between the Corporation and the noteholders might well be proprietary rather than debtor-creditor." Appendix A. *infra*, p. 23a.[4] In short, the decision below is rooted in the far-reaching proposition that promissory notes of a corporation, which are otherwise clearly an unambiguous indebtedness, may be treated for tax purposes as stock in the corporation merely because of its debt-equity ratio. And this proposition is con-

[4] Obviously the true question is what the notes actually were, not what they "might well be."

fidently applied even though the findings clearly disclose that the corporate debtor was adequately financed for its needs. See pp. 23-26, *infra*.

Hence the question which emerges from the undisputed facts is very basic and precise. If a corporate indebtedness is held by stockholders, may the Commissioner, in computing the resulting tax liabilities, regard the indebtedness as a contribution to capital because of the initial spread between the amount of the indebtedness and the investment in stock? In resolving this question in favor of the Commissioner the Court of Appeals has made a grave error which warrants expeditious review by this Court. The decision below is in conflict with decisions of this Court and other Courts of Appeals. At the same time it raises significant issues under the income tax which radiate well beyond the present litigation. These important issues seriously affect the administration of the income tax under the Code of 1954 as well as the Code of 1939.

I. The Decision Below Is in Conflict With Decisions of This Court and Other Courts of Appeals

In *John Kelley Co.* v. *Commissioner*, *supra*, this Court reviewed two cases involving instruments issued by family corporations. The question was whether payments under the instruments were deductible as interest or non-deductible as dividends. The instruments were "hybrid" documents having both "elements of obligations and elements of stock." 326 U.S. at 530. In one of the cases the financial structure of the corporation consisted of $100,000 of stock and $400,000 of "registered notes." The stock and the "registered notes" were held in precisely the same proportions. See 326 U.S. at 524; 3 T.C. at 95-97. At

the outset of its discussion the Court declared, "As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure." *Id.* at 526. The Court then analyzed the case in terms of the legal rights and duties created by the instrument. It affirmed the Tax Court's decision after satisfying itself that the obligations in question had significant legal characteristics of stock. While the instruments were "hybrid" in nature, the Court considered the ratio of 4 to 1 entirely irrelevant in determining their tax treatment.

The decision of the Court of Appeals cannot be reconciled with this Court's opinion in *John Kelley Co. v. Commissioner*. First, this Court was, of course, aware that the indebtedness of a corporation is often much larger than its equity capital. See p. 31, *infra*. But as the text and context of the quoted statement significantly indicate, an indebtedness cannot be treated as stock merely because the indebtedness substantially exceeds the capitalization. Otherwise the Court's analysis which followed was quite pointless. Second, the quoted statement equally indicates that the spread between indebtedness and stock may perhaps become relevant, if at all, only when the stockholders fail to commit "material amounts of capital" to the business. Third, even then there is still no problem except possibly in "extreme situations" where an "obviously excessive debt" is joined with merely "nominal stock investments." Here, however, the Court of Appeals has held precisely the opposite in all three respects. It has treated a plain-spoken indebtedness as an investment in stock merely because of the spread between the amount of the notes and the equity capital.

Moreover, it has so held even though the Corporation had a "material" capital of $50,000, and even though the notes were far from "obviously excessive."[5] In view of this Court's opinion in *John Kelley Co.* v. *Commissioner*, the decision below rests upon an unmistakable error of law.

In holding that the notes represented a contribution to capital because of the debt-equity ratio, the Court of Appeals came into further conflict with recent opinions of the Fifth Circuit in *Rowan* v. *United States*, 219 F. 2d 51 (5th Cir. 1955), and *Sun Properties* v. *United States*, *supra*.

In the *Rowan* case the stockholders of a close corporation made net loans to it of $100,727.05, as compared with a capital investment of $9,000. There, too, the Commissioner sought to treat the indebtedness as stock because of the debt-equity ratio. The Fifth Circuit disapproved the attempt. There is "no authority," the court said, "for the proposition that the stockholders of a corporation may not determine just how much of their funds they care to risk in the form of capital and how much, if any, they are willing to lend as a credit. If they make such a determination and it is clear that such is their intent," the Commissioner may not "rewrite their balance sheet for them and show to be capital what was intended to be a loan." 219 F. 2d at 54. Stockholders of corporations, the court emphasized, "have always been free to commit to corporate operations such capital as they choose and to lend such additional amounts as they may elect to assist in the operation if that is their true intent, always thus reserving the right to share with

[5] See pp. 23-26, *infra*.

other creditors a distribution of assets if the enterprise fails. It would obviously work an unwarranted interference by the courts in ordinary and perfectly proper business procedures for us to say that there can be established, as a matter of hindsight, a ratio of stockholder owned debt to the capital of the debtor corporation." "It is entirely within the competence of Congress to provide by statute for such ratio if it deems it advisable or necessary within the scheme of Federal taxation. It is not within our province to do so. Nor would it further the desirable end of certainty in taxes for us to do so." *Id.* at 55.

The conflicting views of the Fifth Circuit are further articulated in *Sun Properties* v. *United States*, *supra*.[6] There an individual organized a corporation in which he became sole stockholder. The creation of the Corporation was prompted by tax reasons. The stockholder contributed $403 as its entire capital. He then sold a warehouse to the corporation for about $125,000, payable at the rate of $4,000 semi-annually. The initial ratio of debt to equity was about 310 to 1. The installment obligation was interest-free and unsecured. Apart from the warehouse, the corporation had "only nominal assets," and the sales price was "paid out of the rentals received." 220 F. 2d at 172-173. The corporation, like the purchaser here, computed its depreciation deduction on the basis of the sales price, which it treated as its cost for the warehouse. The Commissioner determined, as he did here, that the installment obligation represented a contribution to capital rather than a taxable sale; and hence

[6] See also *Giblin* v. *Commissioner*, 227 F. 2d 692, 698 (5th Cir. 1955).

that the much lower basis of the stockholder carried over to the corporation.

The District Court agreed with the Commissioner, but the Fifth Circuit reversed. Its opinion was cogent and succinct. The question of law, it stated, was whether the facts found by the District Court authorized the conclusion that the transfer was a contribution to capital rather than a sale. The lower court had relied on two factors—the tax motivation of the stockholder and the "unusually high ratio of debts to capital on its books." But neither of these circumstances was "rational proof" that the transaction "was something other than what it purported to be"—a sale of assets for fixed payments. "As for the circumstance that taxpayer is a 'thin corporation,'" the opinion declared, "we do not think this is any ground to infer that this transaction was a contribution to capital." There is "not a particle of proof that it was in fact a contribution to capital nor that it was intended as such." 220 F. 2d at 173-176.

We need hardly add that the decision below and the *Sun Properties* decision are wholly incompatible. In both cases the corporations purchased their fixed assets from their stockholders. In both cases the stockholders held the same portions of the indebtedness and the stock. Indeed, in the *Sun Properties* case there was but one stockholder who owned the whole indebtedness. And in both cases there was a substantial spread between the indebtedness and the equity capital of the corporation. For that matter, here the committed capital was $50,000 and the ratio of debt to stock was 11 to 1; while in the *Sun Properties* case the committed capital was only $403 and the ratio of debt to stock was 310 to 1. Yet here the

Tenth Circuit has held that the sale was a contribution to capital because of the ratio of debt to stock; while there the Fifth Circuit held that an "unusually high ratio of debts to capital" provides "not a particle" of support for such a legal conclusion. The Fifth Circuit squarely considered and rejected the legal standard applied below—that a corporate indebtedness may be treated as stock because of the debt-equity ratio.

The decision below is in still further conflict with the decisions of the Second Circuit in *Commissioner* v. *O.P.P. Holding Corp.*, 76 F. 2d 11 (2d Cir. 1935), and *Page Oil Co.* v. *Commissioner*, 129 F. 2d 748 (2d Cir. 1942); the decision of the Seventh Circuit in *Edward Katzinger Co.* v. *Commissioner*, 129 F. 2d 74 (7th Cir. 1942), *aff'g* 44 B.T.A. 533 (1941); and the decision of the Ninth Circuit in *Maloney* v. *Spencer*, *supra*. In all these cases the courts recognized debts owed by close corporations to their stockholders, though the ratio of indebtedness to equity was substantial or extreme. In *Commissioner* v. *O.P.P. Holding Corp.* the indebtedness was $250,000 and the capital was $10,000—a ratio of 25 to 1. In *Page Oil Co.* v. *Commissioner* the initial indebtedness was $2,761,650 and the equity was $238,350—a ratio of about 12 to 1. The corporation "had no liquid capital with which to operate" and it borrowed extensively. Apart from its initial indebtedness of $2,761,650, the loans, including interest, exceeded $750,000. See 41 B.T.A. at 956. In *Edward Katzinger Co.* v. *Commissioner* the sole stockholder made net loans of $63,809 and the capital was $1,000—a ratio of about 64 to 1. The capital "was inadequate to carry on the business," and the stockholder regularly provided the necessary funds. 129 F. 2d at 75. In *Maloney* v. *Spencer* the stockholders made

net loans of $95,081.48 and the two corporations had no capital other than outstanding contracts. Except for the loans the corporations were "without cash for their operating expenditures." 172 F. 2d at 640.

The Ninth Circuit has compactly summarized these appellate decisions in *Miller's Estate* v. *Commissioner, supra*. "We know of no rule," the Ninth Circuit declared, "which permits the Commissioner to dictate what portion of a corporation's operations shall be provided for by equity financing rather than by debt. It is common knowledge that the choice of procedures in this regard will vary from corporation to corporation and we think that it cannot be said that any particular method of issuance of stock and incurrence of indebtedness can be labeled as 'normal,' and hence subject to approval by the Commissioner." 239 F. 2d at 734. The decision below is entirely at odds with this statement of principle and the appellate adjudications which it reflects.[7]

II. The Decision Below Presents an Important Question of Law for Review by This Court

The decision of the Court of Appeals raises critical issues in the administration of the federal income tax laws. There is no statute or regulation which authorizes the Commissioner to treat a corporate debt as if it were stock on the basis of the debt-equity ratio of the corporation. May the Commissioner nevertheless make believe that notes are stock in computing the tax liabilities which derive from the notes? May he, in

[7] Recently the Second Circuit has expressly recognized and left open the question presented here—whether "an indebtedness valid under state law" can "be disregarded for federal tax purposes" because of the debt-equity ratio. See *Kraft Foods Company* v. *Commissioner, supra*, at 127.

short, function as a self-appointed censor of corporate capitalizations whenever the ratio of debt to equity fails to satisfy him?

These issues, of course, are scarcely confined to the present litigation. They easily extend to all sales or advances by shareholders to closely held corporations, where the resulting indebtedness exceeds the investment in stock. And they particularly concern small or modest enterprises which find it difficult to obtain borrowed capital from outside sources. See Cohen, *Raising Venture Capital for Small and New Business*, in Joint Committee of the Economic Report, Federal Tax Policy for Economic Growth and Stability 673 (1955). Moreover, the answer given below, if correct, readily operates in a variety of tax contexts. Here, in fact, the Court of Appeals has decided three distinct but interrelated matters—the taxability of the payments made on the indebtedness; the deductibility of the interest accrued on the indebtedness; and the basis of the property acquired for the indebtedness.[8] All these matters have been resolved on the same ground—that the indebtedness must be treated as stock because the debt-equity ratio of the Corporation was about 11 to 1.

The decision below is more than far-reaching in scope. It also assures a swelling volume of confusion and litigation unless this Court intervenes. For the strange principle of ratio applied below sets taxpayers and Treasury adrift on a sea of uncertainty. The re-

[8] The ratio principle applied below similarly embraces the deduction of losses where a corporate enterprise fails. For tax purposes a basic distinction is drawn between losses on worthless stock and losses on bad debts. Int. Rev. Code of 1954, §§ 165(g), 166. See, *e.g.*, *Rowan* v. *United States*, *supra*.

sults cannot be otherwise, since the Commissioner is invoking some extra-statutory principle which is conveniently "unconfined and vagrant." Cf. *Schechter Corp. v. United States*, 295 U.S. 495, 551 (1935). For example, here the Tenth Circuit has held that a debt-equity ratio of 11 to 1 transforms an indebtedness into stock. But other Courts of Appeals have refused to treat a corporate indebtedness held by stockholders as invested capital, though the ratio was much higher.[9]

A rational system of taxation presupposes the existence of intelligible rules of law which are uniformly applied. What this Court aptly said in regard to tax procedure applies as well to tax law generally. "Always a taxpayer is entitled to know with fair certainty the basis of the claim against him." *General Utilities Co. v. Helvering*, 296 U.S. 200, 206 (1935). If the decision below stands, no informative rule remains where stockholders sell assets or make loans to their corporations. Tax consequences will easily shift from case to case, depending on the relevance which a particular court attributes to a particular ratio. Indeed, the results will conspicuously differ even when the ratios are identical. Essentially similar transactions will be diversely taxed in response to elusive distinctions. Cf. *Helvering v. Hallock*, 309 U.S. 106, 117-118 (1940). In these very cases promissory notes which are an indebtedness in the Fifth Circuit are regarded as stock in the Tenth Circuit. Yet surely the standards of taxability do not vary from circuit to circuit. If Congress expressly authorized the courts to apply so vagrant a principle as they saw fit, the statute would appropriately be charged with invalid delegation of legislative power and unconstitutional

[9] See pp. 18-19, *supra*.

discriminations in tax burden. Here the Court of Appeals has approved the same roving principle, without benefit of statute. Stockholders who sell assets or make loans to their corporations have no way of knowing whether a debt-equity ratio is good, bad, or indifferent.

The decision below nicely illustrates the confusion which it will inevitably breed. The Court of Appeals has ignored a valid indebtedness on the ground that the ratio of debt to equity was excessive. This conclusion, in turn, assumes the existence of some discernible standard which enables the courts to say when a particular ratio is too high. And apparently the courts are expected to apply this same standard, which nowhere appears in the Code, to endless kinds of business enterprise in all sorts of situations. At present it is unnecessary to wonder what this standard may be—especially since the Court of Appeals has not disclosed it. At the very least, the concept of an excessive debt structure has meaningful significance only as it refers to a corporation bereft of required capital. But here the Court of Appeals has disapproved the debt-equity ratio though the capital structure of the Corporation was obviously adequate.

The undisputed facts reveal how far the Court of Appeals has wandered from good sense as well as the Code. The Corporation started off with an equity capital of $50,000 and a prosperous going business. In the last three fiscal years before the sale on October 1, 1946, the earnings had been $123,974.46, $112,938.03, and $188,971.03. Appendix A, *infra*, p. 10a. At the time of the sale there was every indication that the earnings would increase. The results largely justified the optimistic expectations. In its first fiscal year the

Corporation's net profits were $259,761.65. Though they declined in the following two years to $141,469.87 and $117,767.54, they then rose in the next two years to a peak of $268,750.46. For the six fiscal years 1947 through 1952 the average annual net profits of the Corporation were about $200,000.[10] At the end of its first year the books of the Corporation showed an earned surplus of $155,839.62. After two more years they reflected an earned surplus about twice as large, or $309,907.62. Appendix A, *infra*, pp. 17a, 19a.

The purchase money notes were a far cry from an excessive burden. At the very outset the Corporation had net current assets exceeding $250,000. Even on "a truly conservative" basis it had a working capital of about $105,000 consisting of accounts receivable[11]—a fund "readily available for the continued day-to-day operation of the business." *Samuel H. Kessler*, 26 T.C. 1046, 1053 (1956). The notes neither disturbed the Corporation's credit nor increased its need for credit. The $582,773.54 was payable gradually over somewhat more than ten years. The initial amount due was $50,000, and the balance was payable in equal annual installments of about the same amount. Periodic payments were made without any difficulty.[12]

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[10] The net profit figures are those shown on the Corporation's books before upward adjustment by the Commissioner.

[11] See R. 41.

[12] The Tax Court observes that payments on the notes ceased pending the disposition of the present litigation. Appendix A, *infra*, p. 24a. According to the Tax Court's own findings, the notes were regularly paid from 1946 through 1952. Payments were then deferred, not because the petitioners failed to regard their notes as a true indebtedness, but because the Commissioner persisted in imposing a severe and unwarranted burden on their satisfaction. As the Tax Court itself found, "The Corporation has had sufficient

The notes were "absolved from risks and hazards of the business, except those risks incident to ordinary creditors." *Sabine Royalty Corp.*, 17 T.C. 1071, 1077 (1951). "On all available information, the risk here was a good one. And it cannot be said, in contravention of the testimony at the trial, that the holders of the notes had no reasonable expectation that they would be repaid." *Earle v. W. J. Jones & Son*, 200 F. 2d 846, 851 (9th Cir. 1952). Cf. *Page Oil Co., supra*, at 962. The expectation was more than reasonable; it was correct. In taxation, too, the proof of the pudding is in the eating.

In short, the stockholders were well aware of the capital requirements of the Corporation; in their informed opinion a capital of $50,000 was sufficient; and their business judgment was amply vindicated. The phrase "thin corporation" connotes a studied effort to survive on meager capital though the business requires much more. Here, however, the Corporation was hardly starved for capital. Certainly stockholders are not morally obliged to overcapitalize their enterprise in order to make sure that a corporate debt is not treated as stock. As the Tax Court has said, stockholders need "not contribute any more than the necessary amount of capital." *Gazette Telegraph Co.*, 19 T.C. 692, 699 (1953), *aff'd on other issues*, 209 F. 2d

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funds to pay the installments past due," and all further payments have been merely delayed "pending a judicial determination" whether the Commissioner "is correct." Appendix A, *infra*, p. 19a. It ill behooves the Commissioner to make anything of the deferment which he alone caused by insisting that the payments were dividends. Confronted by the Commissioner's insistence that the notes were stock, the petitioners simply did what any prudent businessman would do and what any competent attorney would advise. Meanwhile the Corporation has continued to pay interest on the remaining installments. Appendix A, *infra*, pp. 19a-20a.

926 (10th Cir. 1954). Nor has Congress designated the Commissioner to serve as custodian of standards for capital investment. He has more than enough to do without delving into such refined corporate problems. And it makes no difference whatever that he might have financed the business differently if he had been in charge of the enterprise. Cf. *Rowan* v. *United States*, *supra*, at 54, 55. Or to restate our conclusion, a business can scarcely be deemed inadequately capitalized if it does exceedingly well on the capital which it has. Surely the Corporation would not have been more successful if the stockholders had aimlessly transferred large sums of additional capital which served no business purpose.[13]

We have said that the decision below derives from some disorderly concept which is incompatible with a rule of law that is uniformly applied. The Treasury itself confirms this analysis. For the Treasury blandly proceeds on the assumption that it may respect or ignore, as it sees fit, a corporate indebtedness held by stockholders. In other words, the Treasury is not always persuaded by its present reasoning. It is quietly indifferent to the debt-equity ratio if indifference happens to suit its purpose. For example, in excess profits tax cases—where the Treasury prefers not to treat a corporate indebtedness held by stockholders as equity capital[14]—its position is indistinguishable from peti-

[13] On the question of "adequacy" the Tax Court merely says that "the average annual net assets or capital of the business increased gradually from $49,939.15 in 1939 to $267,349.30 in 1946." Appendix A, *infra*, p. 23a. But mere growth in net assets illuminates little.

[14] The concept of indebtedness is the same under the excess profits tax as under the income tax. *See Powers Photo Engraving Co.* v. *Commissioner*, 197 F. 2d 704 (2d Cir. 1952); *H. R.*

tioners' position. See *Tri-State Realty Co.* v. *Commissioner*, 180 F.2d 593 (5th Cir. 1950)—net indebtedness of $112,000 and capital of $1,000, or a ratio of 112 to 1; *A. H. Stange Co.*, 1 B.T.A. 58 (1924)—indebtedness of $3,185,000 and capital of $245,000, or a ratio of 13 to 1; *H. H. Hornfeck & Son, Inc.*, 3 B.T.A. 1165 (1926)—indebtedness of $131,296.57 and capital of $10,000, or a ratio of about 13 to 1; *Flint Northown Theatre Co.*, 4 T.C. 536 (1945)—indebtedness of $44,800 and capital of $5,000, or a ratio of about 9 to 1. In all these cases the Treasury was unimpressed by the debt-equity ratio; and it was unimpressed because the resulting tax was larger. However, rules of tax law do not mysteriously change in accordance with the periodic preferences of the Treasury. See *Rosenman* v. *United States*, 323 U.S. 658, 663 (1945).

The decision below presents a serious question, quite apart from its obscure and unsettling effects. It critically confuses the legislative function and the judicial function in income tax law. See *United States* v. *Nunnally Investment Co.*, 316 U.S. 258, 264 (1942); *Commissioner* v. *Korell*, 339 U.S. 619, 626 (1950). Congress has not enacted any statute which in any way provides that a clear-cut indebtedness shall be deemed an equity interest because of the debt-equity ratio. And the courts cannot improvise such a rule on the Commissioner's behalf, unless they are to ignore the vital distinction between adjudication and legislation. Of course, the judicial function in construing statutes "is not a mechanical process from which judgment is excluded." But it is also true that the judi-

DeMolt Co., 7 B.T.A. 7 (1927); *John Kelley Co.*, 1 T.C. 457 (1943), *aff'd*, 326 U.S. 521 (1946); *Tribune Publishing Co.*, 17 T.C. 1228 (1952).

cial function is "very different from the legislative function." "To let general words draw nourishment from their purpose is one thing. To draw on some unexpressed spirit outside the bounds of the normal meaning of words is quite another." *Addison* v. *Holly Hill Co.*, 322 U.S. 607, 617-618 (1944). Only Congress may narrowly define a corporation's indebtedness, for tax purposes, in terms of its debt-equity ratio. Congress expressly did so between 1909 and 1919; it has not done so since.

In 1909 Congress imposed an excise tax on corporations measured by net income. Various deductions were granted, including an allowance for interest on indebtedness. But the indebtedness was recognized only to the extent of paid-up capital stock at the end of the year.[15] In 1913 Congress continued to control the interest deduction in relation to invested capital. The limitation, however, became looser. The indebtedness of a corporation was recognized in an amount "not exceeding one-half of the sum of its interest bearing indebtedness and its paid-up capital stock outstanding at the close of the year."[16] In 1916 the limitation was still further relaxed. Congress now recognized the indebtedness in an amount equal to paid-up capital plus one-half of the interest bearing indebtedness.[17] In 1919 the limitation was completely repealed because of the excess profits tax of World War I.[18] As the Ways and Means Committee stated, "Since borrowed money is not allowed to be included in comput-

[15] Act of August 5, 1909, § 38(2d).

[16] Act of October 3, 1913, § II(G)(b).

[17] Revenue Act of 1916, § 12(a)(3d). See also Revenue Act of 1917, § 1207(1).

[18] Revenue Act of 1918, § 234(a)(2).

ing invested capital for the purpose of the war profits and excess profits tax, it seems only fair to allow as a deduction in computing net income the whole amount of the interest paid during the year." H. R. Rep. No. 767, 65th Cong., 2d Sess. 12-13 (1918).

This chapter of legislative history speaks for itself. When Congress has desired to limit taxwise the amount of indebtedness in relation to invested capital, it has known how to do so and has plainly said so. The only limitation it has ever imposed was closely confined to the deduction for interest. Neither the courts nor the Treasury can fix a limitation on their own when Congress has refused to do so. Taxation is a statutory subject, and any tax "asserted by the Commissioner" must be "authorized by Congress." *Helvering* v. *Griffiths*, 318 U.S. 371, 394 (1943). The obligations of a taxpayer stem from the specific words used by Congress, and not from loose words and phrases like "thin corporation" and "ratio of indebtedness to capital." "Catch words and labels," Mr. Justice Cardozo has written, "are subject to the dangers that lurk in metaphors and symbols, and must be watched with circumspection lest they put us off our guard." *Hennefford* v. *Silas Mason Co.*, 300 U.S. 577, 586 (1937). His admonition is especially appropriate in tax law, where the words used by Congress provide the governing rule.

In sum, the decision below does precisely the sort of thing that this Court, in *Commissioner* v. *Culbertson*, 337 U.S. 733 (1949), said cannot be done. In that case the Commissioner contended that a "partnership" in tax law was something different from a "partnership" in commercial law. And there, as here, he devised certain rules of his own which he attributed

to Congress. This Court was not persuaded. We cannot do better than quote from Mr. Justice Frankfurter's concurring opinion. The Internal Revenue Code, he wrote, does "not purport to announce a special concept of 'partnership' for tax purposes differing from the concept that rules in ordinary commercial-law cases." "The term carries its own meaning, just as does 'negligence' in the Federal Employers' Liability Act, because such a common law concept has a content familiar throughout the country to whom the law speaks. The basic criteria which determine its applicability have been so well and so long established that they were implicitly incorporated by the Internal Revenue Code's definition of partnership." Since the term "partnership" does not have "a content peculiar to the Internal Revenue Code," the "general rule" of partnerships also controls in tax cases. Therefore, if individuals have joined together in a partnership, "they do not cease to be in it when the tax collector appears." 337 U.S. at 750-754.

The same analysis applies here. In these cases, as in the *Culbertson* case, the Commissioner has substituted his own "special" and "peculiar" notions of "sale" and "indebtedness" for the familiar concepts which prevail in "ordinary commercial-law cases." Here, too, he has forgotten that these settled concepts were "implicitly incorporated" in the Code. If Congress had intended to abandon them for others, it would have said so unequivocally. And so a genuine sale which creates a genuine indebtedness does not suddenly become something else "when the tax collector appears."[19]

[19] Here the local law of Oklahoma determines the content of the rights and obligations created by the notes involved. *Dayton*

The Commissioner is simply attempting to obtain by adjudication what he has failed to obtain by legislation. As the American Law Institute has thoughtfully concluded, "present law" does not place "any limitation upon the *amount* of indebtedness held pro rata by shareholders." (Italics in original.) Indeed, the Institute carefully observes that Congress would be very unwise if it adopted any such limitation:

> "Policy considerations . . . indicate that there should be no upper limit upon the permissible ratio of pro rata debt to capital. Fixing an upper limit upon this ratio would unduly circumscribe the available methods of financing by failing to take into account the fact that extremely high debt-capital ratios are common, and even necessary, in certain industries. Depriving certain closely held corporations of the tax advantages of debt financing would constitute discriminatory treatment in favor of competing corporations which were in fact able to borrow from outsiders.
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> Moreover, if it be conceded that pro rata indebtedness in ratios up to 4 to 1 is to be recognized, the tax saving or tax avoidance made possible by further increasing the debt ratio is hardly significant. For example, if by utilizing a ratio of 4 to 1 the taxpayer is able to accomplish a tax saving of 80%, increasing the ratio to 9 to 1 will permit additional savings of only 10%; and increasing the ratio infinitely thereafter will permit the further saving of only 10%. If the initial 80% saving is regarded as proper, it would seem almost

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Michigan R. Co. v. *Commissioner*, 112 F. 2d 627, 630 (4th Cir. 1940); and see generally *Blair* v. *Commissioner*, 300 U.S. 5, 9-10 (1937); *Helvering* v. *Fuller*, 310 U.S. 69, 74 (1940); *Helvering* v. *Stuart*, 317 U.S. 154, 161-162 (1942). There is no principle of Oklahoma law which would treat the notes as other than an enforceable indebtedness deriving from a sale of assets.

pointless to pursue the two remaining 10% segments."[20]

In refusing to recognize the purchase money notes as a genuine indebtedness, the Court of Appeals has raised basic issues which envelop a wide area of tax law. These issues peculiarly affect small corporate enterprises and their individual sources of borrowed capital. Only this Court can set these issues at rest.[21]

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[20] A.L.I. Federal Income Tax Statute 263-264 (Tent. Draft No. 7, 1952). See also Cohen, Surrey, Tarleau and Warren, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders*, 52 Col. L. Rev. 1, 28-29 (1952).

[21] If this Court should grant the petitions and then reverse the decision below, a subsidiary question will remain whether the notes qualify as "securities" within sections 112(b)(5), 112(c)(2), and 113(a)(8)(A) of the 1939 Code. This question will involve only the Corporation's basis for computing depreciation. The Seventh Circuit has held that ten-year unsecured promissory notes are "securities." *Burnham* v. *Commissioner*, 86 F. 2d 776 (7th Cir. 1936), *cert. denied*, 300 U.S. 683 (1937). On the other hand, this Court has held that ten-year and twenty-year debenture bonds are not "securities." *Bazley* v. *Commissioner*, 331 U.S. 737 (1947). The courts below did not reach this question because they held that the notes constituted stock in the Corporation. In the event of reversal, we assume that this Court will remand the case so that they may initially pass on the question. Cf. *Commissioner* v. *Lo Bue*, 351 U.S. 243, 250 (1956).

CONCLUSION

For the foregoing reasons the petitions for a writ of certiorari should be granted.

Respectfully submitted,

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